Internal Revenue Service
memorandum

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FS:IT&A:TCOswald

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to: District Counsel, Greensboro SE:GBO
Attn: James Gray

from: Assistant Chief Counsel (Field Service) CC:FS

subject: [redacted]

This is in response to your October 8, 1991 request for tax litigation advice.

ISSUE

Whether I.R.C. § 481(b)(1) allocations must be included in base period income.

CONCLUSION

Section 481(b)(1) allocations must be included in base period income.

BACKGROUND

By notice of deficiency dated [redacted] the Internal Revenue Service ("Service") proposed various adjustments to [redacted]'s ("taxpayers") joint Federal income tax for the taxable years [redacted] and [redacted] The Service also asserted additions to tax for fraud. As part of the proposed adjustments, the Service increased the taxpayers' taxable income in [redacted] to reflect a change from a hybrid, to an accrual method of accounting, for the [redacted] taxable year pursuant to section 481(a).

The taxpayers have agreed to substantially all issues, including the section 481(a) adjustment, which amounts to $[redacted]. The only issue which is in dispute is how to compute the limitation on tax attributable to the section 481(a) adjustment in the year of the accounting change pursuant to section 481(b)(1). The disputed issue involves the use of the income averaging provisions (sections 1301 through 1305), as those sections were in effect between [redacted] and [redacted][1], to determine the tax limitation under section 481(b)(1).

Specifically, it is your position that when the tax attributable to each section 481(b)(1) allocation is determined by using the income averaging method, the section 481(b)(1) allocations should also be included in base period income when the allocations occur in years which are also base period years in the income averaging calculation. The taxpayers' position is that when a section 481(b)(1) allocation occurs in a base period year, it should not be included in base period income.

Section 481(a) allows the Service, in the year of an accounting change, to increase or decrease a taxpayer's taxable income to reflect a change in his or her method of accounting to prevent amounts from being omitted or duplicated as a result of such change. I.R.C. § 481(a). Provided the section 481(a) adjustment increases taxable income by more than $3,000.00, and the taxpayer used the method of accounting from which the change is made during the two years immediately preceding the year of change, section 481(b)(1) limits the amount of tax in the year of change attributable to a section 481(a) adjustment. I.R.C. § 481(b)(1).

Pursuant to section 481(b)(1), the tax attributable to a section 481(a) adjustment cannot exceed the lesser of the tax computed under section 481(b)(1) or the tax computed on the entire section 481(a) adjustment in the year of the accounting change. I.R.C. § 481(b)(1). Under section 481(b)(1), the limitation on tax is computed by: (1) allocating one-third of the section 481(a) adjustment to the year in which the accounting method changed and one-third to each of the two years immediately preceding the year of change; (2) computing the increase in tax liability attributable to each portion of the section 481(a) adjustment in each year to which such portion was allocated;[2] and (3) totaling all of the increases. I.R.C. § 481(b)(1). Section 481(b)(1) affects only the amount of tax in the year of the

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[1]Unless otherwise noted, references to the various income averaging provisions are based on those sections as they existed, during [redacted] to [redacted], pursuant to section 232 of the Revenue Act of 1964, Pub. L. No. 88-272, 78 Stat. 19, 105 (1964) ("1964 Act"), as amended by the Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487, 586 (1969) ("1969 Act").

[2]For simplification, each portion of a section 481(a) adjustment which is allocated to the years specified under section 481(b)(1) will be referred to herein as a section 481(b)(1) allocation. Similarly, each year to which a section 481(b)(1) allocation is allocated shall be referred to as an allocation year.

accounting change. There is no change in the tax liability of the two allocation years preceding the year in which the accounting method was changed. I.R.C. § 481(b)(1). The example which follows demonstrates a section 481(b)(1) calculation and how the income averaging method is used to compute the tax attributable to each section 481(b)(1) allocation.

For purposes of this example we assume a taxpayer using the cash basis of accounting in 1980 and 1981. The taxpayer's method of accounting changed to an accrual method in 1982. A positive section 481(a) adjustment of $900,000 in the taxpayer's 1982 taxable income resulted. The section 481(b)(1) allocation in each allocation year is $300,000. Taxable income before the section 481(b)(1) allocation was $20,000 in each allocation year. All figures are assumed. The section 481(b)(1) limitation is calculated as follows:

Allocation Year	Preallocation Taxable Income	Tax liability Before Allocation	Taxable Income After Allocation	Tax Liability After Allocation	Increase in Tax from Allocation
1980	$20,000	$3,000	$320,000	$93,000	$90,000
1981	$20,000	$3,000	$320,000	$93,000	$90,000
1982	$20,000	$3,000	$320,000	$93,000	$90,000
Section 481(b)(1) limitation on 1982 tax attributable to section 481(a) adjustment:					$270,000

In the statutory notice of deficiency issued to the taxpayers, the income averaging method was used to compute the tax on taxable income after adding the section 481(b)(1) allocation to the original taxable income of each allocation year (i.e. applying income averaging to taxable income of $[redacted] to determine a tax of $[redacted] in each of [redacted], [redacted] and [redacted]. This involves two steps under the income averaging provisions for each allocation year.

In the first step, averagable income is determined for a particular computation year by subtracting 120 percent of the average base period income from the taxable income of that computation year. I.R.C. § 1302(a)(1). Certain adjustments, not here relevant, must be made in taxable income of the computation year, before arriving at averagable income.[3] The computation year is the taxable year for which the taxpayer chooses the benefits of income averaging. I.R.C. § 1302(c)(1). In the example, each allocation year is also a computation year, when the tax attributable to the section 481(b)(1) allocation in such year is determined.

[3]Under section 1302, before determining averagable income, taxable income for the computation year is reduced by amounts to which section 72(m)(5) or (q)(1) applied and amounts included in the income of a beneficiary under section 667(a). I.R.C. § 1302(a)(2).

The base period is the four years immediately preceding the computation year. I.R.C. § 1302(c)(2). A base period year is any year included in the base period. I.R.C. § 1302(c)(3). Base period income is, generally, the taxable income for any base period year.[4] I.R.C. § 1302(b)(2). Average base period income is one-quarter of the sum of the base period incomes for the base period. I.R.C. §1302(b)(1). Thus, averagable income is a function of taxable income in the year which the tax is being determined and the amount of taxable income in the four prior years. It is also important to note that each allocation year may be either a computation year or a base period year, depending on the particular allocation year in which the tax attributable to the section 481(b)(1) is being determined.

The second step involves the computation of the tax attributable to averagable income for the computation year. This amount is determined by computing the increase in tax resulting from adding 20% of averagable income to 120% of the average base period income and multiplying this increase in tax by five. The total tax for the computation year is the sum of this product and the amount of tax on 120 percent of the average base period income.[5] I.R.C. § 1301; Treas. Reg. § 1.1304-5(c).

The remainder of the example illustrates how averagable income is calculated (not the tax) and the difference between the taxpayers' and Service's method in using income averaging to determine the tax attributable to the section 481(b)(1) allocation in the [redacted] and [redacted] allocation years.

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[4]Like taxable income in the computation year, base period income is also subject to certain adjustments. The base period income for any taxable year is the taxable income for such year, increased by the excess of the amount excluded from gross income under sections 911 and 931 to 935 over the deductions properly allocable thereto, and decreased by amounts included in the income of a beneficiary of a trust under section 667(a). I.R.C. §§ 1302(b)(2)(A) and (B).

[5]According to the legislative history, "[t]he device of including one-fifth of the averagable income in the tentative tax base, computing the tax attributable to this amount, and then multiplying this by 5, achieves a result which is substantially similar . . . to including one-fifth of the income eligible for averaging in the taxable income base of each of the prior 4 years and of the current year. The advantage of making the computation in this manner is that it is not necessary to recompute the tax for each of the four prior year in order to obtain this result." H.R. Rep. No. 749, 88th Cong., 1st Sess. 11 (1963).

[redacted] Allocation/Computation Year

Service's Method	Taxpayers' Method
1. Determine Taxable Income for the Computation Year	
$[redacted]	$[redacted]
2. Determine Average Base Period Income	
[redacted]	[redacted]
[redacted] $[redacted]	$[redacted]
Total $[redacted]	$[redacted]
1/4 Total $[redacted]	$[redacted]
3. Determine Averagable Income for the [redacted] Computation Year	
[Taxable income in computation year - 120%(Avg. Base Period Income)]	
$[redacted] - 1.20($[redacted])	$[redacted] - 1.20($[redacted])
$[redacted] - $[redacted]	$[redacted] - $[redacted]
$[redacted]	$[redacted]

[redacted] Allocation/Computation Year

Service's Method	Taxpayers' Method
1. Determine Taxable Income for the Computation Year	
$[redacted]	$[redacted]
2. Determine Average Base Period Income	
[redacted]	[redacted]
[redacted] $[redacted]	$[redacted]
[redacted] $[redacted]	$[redacted]
Total $[redacted]	$[redacted]
1/4 Total $[redacted]	$[redacted]
3. Determine Averagable Income for The [redacted] Computation Year	
$[redacted] - 1.20($[redacted])	$[redacted] - 1.20($[redacted])
$[redacted] - $[redacted]	$[redacted] - $[redacted]
$[redacted]	$[redacted]

Thus, the taxpayers' method of not including the appropriate section 481(b)(1) allocations in base period income enhances the amount of taxable income eligible for averaging.

DISCUSSION

We agree with your conclusion that whenever the tax attributable to a section 481(b)(1) allocation is determined under the income averaging method, any other section 481(b)(1) allocations attributable to the same section 481(a) adjustment, which are allocated to base period years must be included in base period income.

Section 481 states, in pertinent part:

> (a) GENERAL RULE--In computing the taxpayer's taxable income for any taxable year (referred to in this section as the "year of the change")--
>
> > (1) if such computation is under a method of accounting different from the method under which the taxpayer's taxable income for the preceding taxable year was computed, then
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> > (2) there shall be taken into account those adjustments which are determined to be necessary solely by reason of the change in

> order to prevent amounts from being duplicated or omitted, except there shall not be taken into account any adjustment in respect of any taxable year to which this section does not apply unless the adjustment is attributable to a change in the method of accounting initiated by the taxpayer.
>
> (b) LIMITATION ON TAX WHERE ADJUSTMENTS ARE SUBSTANTIAL--
>
> (1) THREE YEAR ALLOCATION.--If--
>
> (A) the method of accounting from which the change is made was used by the taxpayer in computing his taxable income for the 2 taxable years preceding the year of the change, and
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> (B) the increase in taxable income for the year of the change which results solely by reason of the adjustments required by subsection (a)(2) exceeds $3,000,
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> then the tax under this chapter attributable to such increase in taxable income shall not be greater than the aggregate increase in the taxes under this chapter (or under the corresponding provisions of prior revenue laws) which would result if one-third of such increase in taxable income were included in taxable income for the year of the change and one-third of such increase were included for each of the 2 preceding taxable years.

We view section 481(b)(1) as creating a ratable, hypothetical allocation of the section 481(a) adjustment over a three-year period. "[C]ompute under section 481(b)(1) the tax attributable to the adjustments referred to in subparagraph (1) of this paragraph for the taxable year of the change and the two preceding taxable years as if an amount equal to one-third of the net amount of such adjustments had been received or accrued in each of such taxable years." Treas. Reg. § 1.481-2(c)(2). It is "as if" the taxpayer originally received the section 481(b)(1) allocations as additional taxable income in each year of the three years specified in section 481(b)(1). The only difference is that the total increase in tax liability is incurred in the third period, rather than in the period the allocations were deemed to be realized. *See*, I.R.C. § 481(b)(1). Thus, under the income averaging provisions, section 481(b)(1) allocations which occur in base period years should be properly included in base period income. Not to do so would ignore the premise that the section 481(b)(1) allocations are deemed to be received in such years.

Under section 481(b)(1), the increases in tax attributable to each section 481(b)(1) allocation in each allocation year are totaled to determine the limitation on tax in the year of accounting change. Each section 481(b)(1) allocation is income averaged in its respective allocation or computation year. Thus, in computing the limitation on tax under section 481(b)(1) for a section 481(a) adjustment in [redacted], [redacted] and [redacted] would be two of the base period years of the [redacted] computation year. [redacted] would be one of the base period years of the [redacted] computation year. No allocation years would be base period years when [redacted] is the computation year.

For purposes of determining the increase in tax attributable to the section 481(b)(1) allocation in [redacted] the taxpayers propose to include the section 481(b)(1) allocation in taxable income of the [redacted] computation year, but not to include the section 481(b)(1) allocations allocable to [redacted] and [redacted] in the taxable income of the [redacted] or [redacted] base period years. Similarly, the taxpayers would include the section 481(b)(1) allocation in the taxable income of the [redacted] computation year, but not in the taxable income of the [redacted] base period year. When [redacted] is the computation year, there are no allocation years which are also base period years. Under the taxpayers' proposed computation method, the section 481(b)(1) allocations allocated to [redacted] and [redacted] would be included in taxable income based on the distinction of whether such year was either a base period year or a computation year.

We are unpersuaded by the taxpayers' statutory construction argument. They state that since section 1302(b)(2) does not specifically refer to section 481(b)(1) allocations, such allocations should not be included in base period income. Section 1302(b)(2) lists two adjustments to base period income.[6] But, the taxpayers nonetheless propose to include the section 481(b)(1) allocation in the taxable income of the computation year when section 1302(a), which lists the adjustments to computation year taxable income,[7] makes no mention of section 481(b)(1) allocations. We do not understand how the taxpayers can reconcile this inconsistent treatment of the section 481(b)(1) allocations in the computation and base period years, especially since section 481(b)(1) allocations are defined in that section as "taxable income." There is no basis for the taxpayers to argue that a section 481(b)(1) allocation could not

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[6] See footnote 4, supra.

[7] See footnote 3, supra.

be an increase to taxable income in a base period year.

We find support in the language of sections 481(b)(1), 1302(a) and 1302(b)(2). Section 481(b)(1) states that the adjustment is to be included in "taxable income for the year of the change . . . and the two preceding taxable years." I.R.C. § 481(b)(1). Section 1302(a) states that "averagable income means the amount by which taxable income for the computation year exceeds 120 percent of average base period income." I.R.C. § 1302(a). Section 1302(b)(2) states that "base period income for any taxable year is taxable income for such year." I.R.C. § 1302(b)(2). (Emphasis added). Before any adjustments are made to taxable income in either the computation or respective base period years, the taxable income of those years should properly include any section 481(b)(1) allocation, regardless of whether such year is a computation year or a base period year.

The taxpayers' second argument is irrelevant. The taxpayers rely on language found in the legislative history of the income averaging provisions and Income Averaging Provisions, G.C.M. 36,175, I-93-74 (March 3, 1975), that simplification and liberalization of the income averaging provisions under the 1969 Act, support their contention that section 481(b)(1) allocations should be excluded from base period income. We admit this argument has some persuasive merit in determining whether income averaging should be considered in computing the increase in tax attributable to each section 481(b)(1) allocation. However, our concern is to determine the correct method of computation when section 481(b)(1) and the income averaging provisions may be used together. Congress' intent in legislating the changes to the income averaging provisions under the 1969 Act was not meant to allow the treatment of section 481(b)(1) proposed by the taxpayers. This is not a matter of simplification or liberalization of the income averaging provisions, but rather, a matter of correct computation. Further, we believe that G.C.M. 36,175 is inapplicable since it involved the issue of whether a taxpayer could use income averaging in a particular tax year, when the taxpayer's method of accounting changed in one of the base period years. It concluded that the taxpayer could income average, but lends no insight into the correct method to compute a section 481(b)(1) limitation using the income averaging provisions.

Finally, the taxpayers' argue that including the section 481(b)(1) allocation in base period income creates an absurd tax result. They state that including a section 481(b)(1) allocation in base period income creates an increase in tax attributable to the section 481(a) adjustment calculated at an effective tax rate of approximately 75 percent. They believe this would be persuasive logic to the court, since the maximum marginal tax rate in [redacted] was 50 percent. We disagree.

Section 481(b)(1) limits the tax liability in the year of an accounting method change attributable to a section 481(a) adjustment. Section 481(b)(1) only affects the amount of tax in the year of the accounting change. The effective tax rate should be determined based upon the entire amount of tax computed under section 481(b)(1) in relation to the entire amount of the section 481(a) adjustment. The taxpayers have apparently compared the entire amount of tax computed under section 481(b)(1) to the section 481(b)(1) allocation allocated to the year of the accounting change, one-third of the amount to which the tax should be compared.

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DANIEL J. WILES

By: Gerald M. Horan

GERALD M. HORAN
Senior Technician Reviewer
Income Tax and Accounting Branch
Field Service Division